TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Update on State Legislation | ITEM NUMBER: 8

ATTACHMENT(S): 4

ACTION: X | MEETING DATE: May 3, 2000

INFORMATION: ___ | PRESENTER: Ed Derman

SUMMARY

Staff has prepared the attached analyses and recommended positions on the following measures for the Board's consideration:

Attachment	Bill Number	Author	Subject
1	AB 107	Knox	Tobacco divestment
2	SB 1928	Haynes	National security concerns on investment performance
3	SB 2122	Ortiz	Joint Retirement System Investment Advisory Board
4			Legislative Summary

Mr. Derman will provide an overview of the update on state legislation.

<u>Assembly Bill 107</u> **Assembly Member Knox (As amended 2/29/00)**

<u>Position:</u> **Oppose (Staff recommendation)**

<u>Proponents</u>: **CFT, CTA, State Treasurer Angelides, UTLA**

<u>Opponents</u>: **None known**

SUMMARY

AB 107 prohibits new or additional investments in tobacco companies by the California State Teachers' Retirement System (CalSTRS) and the California Public Employees Retirement System (CalPERS), on and after January 1, 2001 and requires a divestment of existing investments by July 1, 2002.

HISTORY

In 1997, two tobacco divestment bills, AB 1744 (Knox) and SB 1433 (Hayden), were introduced but failed passage.

CURRENT PRACTICE

The CalSTRS passively and actively invests a portfolio valued at over $100 billion. The portfolio is broadly diversified and ranges from publicly traded bonds to privately held partnerships. At the end of last fiscal year, CalSTRS' portfolio allocation across asset classes was 70 percent domestic and international equity, 25 percent domestic fixed income, and 5 percent private equity. Currently, CalSTRS does not adhere to any investment policy restricting the holding of equities in any particular industry or sector in its portfolio, such as tobacco.

DISCUSSION

As of December 31, 1999, CalSTRS held domestic and international equities in 22 companies that manufacture and distribute tobacco products, at a market value of $319,270,861, or less than one half of one percent of equity holdings. The bill (1) prohibits *new* or *additional* investments by CalSTRS and CalPERS in tobacco companies on and after January 1, 2001 and (2) requires the divestment of existing investments by July 1, 2002.

AB 107 defines a tobacco company broadly as " … a business entity that makes more than 10 percent of their gross revenue from tobacco products or have more than 10 percent of their personnel or has more than 10 percent of its business activity in tobacco products." Such a definition could encompass the business activities of retailers, transportation companies, chemical companies, flavoring companies, and advertisers resulting in a very long list of companies in the CalSTRS portfolio that would be targeted for divestment, with a market value exceeding the $319 million for the 22 companies cited earlier.

As an investment sector, tobacco stocks have had mixed results during the past six years. At the April 2000 Investment Committee meeting, the Teachers' Retirement Board (Board) was informed by various consultants, including Pension Consulting Alliance, Inc., that tobacco divestment would not increase the overall risk of CalSTRS aggregate portfolio. However, the consultants could not determine what impact, if any, tobacco divestment would have on the future investment returns of CalSTRS' aggregate portfolio. As a result, the Board chose to address investments in tobacco in the context of larger investment policy issues: the benchmark the system uses to determine specific investments and the extent to which CalSTRS delegates investment portfolio decisions to external portfolio managers.

At the April 2000 Investment Committee meeting, staff and the General Consultant were directed to prepare a policy to modify the benchmark against which investments are measured. This policy would be presented and considered at the May 2000 meeting. Under the policy, the benchmark will be modified when it is in the economic interest of the System do so, when a more cost efficient alternative is available or when an industry or sector is exposed to economic risk. The indicators of significant economic risk would include product liability judgements, industry-wide bankruptcy filings and regulatory and/or legislative actions.

As a result, the Board is developing a policy with respect to investing in sectors of the economy that appear to have extraordinary risk associated with it. As that level of risk may change over time, it is more appropriate that all decisions be maintained by the Board, rather than enacted in statute, which would require additional legislative action to modify in response to changing conditions.

FISCAL IMPACT

Benefit Program Costs – While the performance of the investment portfolio impacts the benefits CalSTRS may offer its membership, AB 107 does not directly impact the benefit programs.

Administrative Costs – The divestment of equities in tobacco companies as broadly defined would increase financial risk and reduce diversification of the investment portfolio. According to the BARRA Tobacco Divestiture Study of April 5, 2000, the divestment of tobacco company holdings would result in substantial transaction costs as tobacco equities are sold and the proceeds reinvested in other companies. BARRA estimates the cost of selling US tobacco holdings and reinvesting the proceeds for CalSTRS U.S. tobacco holdings to be approximately $3.164 million or 1.48 percent of CalSTRS U.S. tobacco holdings. For the international portfolio, the estimated costs of selling CalSTRS tobacco related holdings and reinvesting the proceeds was estimated at $1.191 million, or 1.02 percent of CalSTRS tobacco holdings.

In addition to these direct transaction costs, the BARRA study also found that tobacco divestiture increases the total risk of the portfolio as well as the portfolio's risk relative to the S&P 500 benchmark. This increased risk is equal to approximately two basis points (.02 percent) or $22 million in the current CalSTRS portfolio. Depending on the time period measured, this figure represents the potential gain or loss to the portfolio as a result of tobacco divestiture.

RECOMMENDATION

Oppose. The Board is in the process of developing a process to evaluate whether the economic risk associated with particular investments warrants excluding them from the system's investment benchmarks. Maintaining that authority with the Board, rather than being enacted in statute, would permit the system's investments to be more responsive to changes in the investment climate.

Senate Bill 1928 **Senator Haynes (As amended 3/27/00)**

Position: **Oppose (Staff recommendation)**

Proponents: **None known**

Opponents: **None known**

SUMMARY

SB 1928 discourages the Teachers' Retirement Board (Board) and the Board of Administration of the Public Employees' Retirement System (CalPERS) from investing in foreign companies that may pose national security and human rights threats. The bill establishes the Capitol Markets Task Force Board to make recommendations to the boards regarding threats to national security and human rights, and social concerns material to the performance of the systems' investments.

HISTORY

AB 2745 (Kaloogian) requires the internal and external fund managers of California State Teachers' Retirement System (CalSTRS) and CalPERS to perform and disclose due diligence on potential investments in foreign companies that pose a threat to national security. The bill also requires both systems to hire an independent auditor to evaluate present and proposed investments in foreign companies and report quarterly to their respective boards and the Legislature on such investments. Finally, the bill allows the auditor, when warranted, to recommend divestment of companies posing a threat to national security.

Chapter 341, Statutes of 1999 (SB 105—Burton) required CalSTRS to report on its investments in companies operating in Northern Ireland.

Chapter 216, Statutes of 1999 (SB 1245—Hayden) required CalSTRS to report on investments in companies that owe compensation to victims of slave and forced labor from 1929 to 1945.

CURRENT PRACTICE

CalSTRS investments are managed by internal staff and a number of fund managers. The system's investment portfolio is diversified and includes real estate, fixed income and public and private equities. As of June 30, 1999 approximately 24 percent of the fund's investments are in international equities. About 50 percent of the system's international equity portfolio is passively invested to replicate various international stock indices.

The Board follows a policy to support legislation and shareholder resolutions that "reduce social injury." In addition, its existing corporate governance policy is to consider social factors to the extent such factors bear on the financial advisability of the investment.

DISCUSSION

According to the author's office, the intent of the bill is to "address the scandal related to CalPERS foreign investments and to address those "bad actors" on the global scene, such as those responsible for the infliction of slavery and genocide in the Sudan." The bill is intended to apply only to international investments by the retirement systems.

SB 1928 establishes a task force that would make recommendations on human rights and national security concerns, and on social concerns that could be material to the performance of the systems' investments. The bill is unclear, however, on the types of recommendations the task force would make and on what basis.

In addition, in its current form, SB 1928 doesn't identify the appointment of Capital Markets Task Force Board members, the task force's size, the criteria to determine membership on the task force, the length of terms and board member compensation.

It appears that the recommendations that the task force would make with respect to national security and human rights concerns would not be based on the impacts of these issues on investment performance. Given the fiduciary obligation of the Board to act exclusively on behalf of CalSTRS members and beneficiaries, any actions by CalSTRS that resulted in a cost to the retirement fund would be inconsistent with that fiduciary duty. In addition, the bill does not impose any fiduciary liability on the task force for its recommendations. If the Board acted on the basis of those recommendations, and the action turned out to be contrary to the fiduciary interests of CalSTRS members, the Board members would be individually liable.

FISCAL IMPACT

<u>Benefit Program Costs</u> – No impact.

<u>Administrative Costs</u> – The bill does not require any specific action by the CalSTRS. However, the bill is silent as to who would bear the costs of the task force, which depending on the composition and responsibilities ultimately assumed by its members, could be tens of thousands of dollars per year.

To the extent that the Board acts upon recommendations of the task force, this bill could result in significant investment costs. For example, if investment diversification goals are not realized in cases where the Board follows task force recommendations, this could lead to investment losses or cause the system to incur significant transaction costs.

RECOMMENDATION

Oppose. The bill creates a task force with the authority to make recommendations to the Board on unspecified matters. Such recommendations could conflict with the Board's fiduciary responsibility to CalSTRS members and beneficiaries, a responsibility not shared by the task force.

Senate Bill 2122 **Senator Ortiz (As introduced 2/25/00)**

Position: **Oppose (Staff recommendation)**

Proponents: **None known**

Opponents: **None known**

SUMMARY

SB 2122 establishes the Joint Retirement System Investment Advisory Board until 2004 to make recommendations to the boards of the California State Teachers' Retirement System (CalSTRS) and the California Public Employees' Retirement System (CalPERS) on active and passive investments and asset allocation.

HISTORY

AB 107 (Knox) prohibits new or additional investments by the CalSTRS and CalPERS on and after January 1, 2001, in tobacco companies and requires a divestment of those existing investments by July 1, 2002.

AB 2745 (Kaloogian) requires CalSTRS' and CalPERS' internal and external fund managers to perform and disclose due diligence with respect to potential investments in foreign companies that pose a threat to national security and to hire an independent auditor to review and report to the Teachers' Retirement Board (Board), the CalPERS Board of Administration and the State Legislature regarding present and proposed investments in those companies.

SB 1928 (Haynes) creates the Capital Markets Task Force Board to make recommendations on investments by CalSTRS and CalPERS in foreign companies and concerns related to national security or human rights of material concern to the performance of those investments.

CURRENT PRACTICE

CalSTRS has an Investment Branch and internal and external fund managers that oversee and manage the system's extensive portfolio which consists of, among other things, domestic and international equities, bonds, and real estate. A large portion of the system's portfolio is passively managed through numerous market indices. In addition, CalSTRS uses consultants while it develops its investment strategies. For example, CalSTRS retains a general consultant; two external consultants are used for special investment-related projects; and all of the external investment managers are consulted from time to time on investment related matters.

The Board's Investment Committee hears investment matters with the advice of program staff and numerous consultants. While this committee does not make specific decisions related to individual investments, it does set policy which guides program staff and other managers in the management of the system's assets.

Proposition 162, the Pension Simplification Act of 1992 (Article XVI of the California Constitution, Section 17), granted public employees' retirement systems sole and exclusive constitutional authority over their respective investment and administrative decisions. The investment powers of the Board are broad and exclusive; the duty of a public retirement system board to its participants and beneficiaries takes precedence over any other duty set forth by the Legislature. The Board has the sole authority to act as fiduciary for the Plan.

DISCUSSION

SB 2122 creates the Joint Retirement System Advisory Board until 2004, consisting of the following members:

- The Governor
- The Treasurer
- The Controller
- Two members of the Teachers' Retirement Board
- Two members of the Board of Administration of CalPERS
- Six investment professionals

The advisory board would be authorized to make recommendations to CalSTRS and CalPERS with respect to active versus passive investment and asset allocation. The advisory board would not, however, establish investment policies.

Presumably, the bill is intended to provide the Board the advantage of outside expertise while the Board considers its investment management strategy with respect to asset allocation and active versus passive investments. It does this by creating an advisory board consisting of the Governor, the Treasurer, the Controller, two members each from the boards of CalSTRS and CalPERS and six outside investment professionals. However, the Governor appoints most of the Board members, the Treasurer and the Controller already sit on the Board, and, as indicated earlier, CalSTRS staff retain consultants who provide outside expertise in developing CalSTRS' investment strategies. Consequently, it's not clear what additional value the advisory board would give CalSTRS or the Board.

In addition, it would be inappropriate for outside entities that advise the Board to participate in CalSTRS-related activities. Consequently, only investment managers who do not currently have or do not plan on having a business relationship with CalSTRS could participate in this advisory board.

Finally, the bill, in its current form, is unclear concerning

- The specific qualifications of the investment professional sitting on the advisory board
- Who would appoint the investment managers, and for what period of time would those professionals serve on the advisory board
- Who would pay any expenses of the advisory board

FISCAL IMPACT

Benefit Program Costs – None.

Administrative Costs – The bill would have little direct impact on administrative costs, although the bill does specify who would pay the expenses of the advisory board.

RECOMMENDATION

Oppose. It does not appear that establishing an advisory board would provide any additional information to the Board, because CalSTRS already obtains outside expertise from investment consultants when developing its investment management strategy.

Attachment 4
Investment Committee Item-8
May 3, 2000

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

LEGISLATIVE SUMMARY – INVESTMENT COMMITTEE

1999-2000 Regular Session – April 18, 2000

BILL NO. >>> **STATUS** <<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<

AB 107

AUTHOR: Assembly Member Knox
TITLE: Tobacco divestment
AMENDED: 2/29/00
LOCATION: Senate PE&R
BOARD POSITION: Oppose (Staff recommendation)

SUMMARY: Prohibits new or additional investments in tobacco companies by CalSTRS and CalPERS on and after January 1, 2001 and total divestment by July 1, 2002.

COSTS: Benefit program – None
Administrative – Pending

P – CFT, CTA, State Treasurer, UTLA

O – None Known

AB 2745

AUTHOR: Assembly Member Kaloogian
TITLE: Public retirement fund investments in national security
LOCATION: Assembly PER&SS
BOARD POSITION: Oppose*

SUMMARY: Requires CalSTRS and CalPERS to report on potential investments in foreign companies that pose a threat to national security.

COSTS: Benefit program – No impact
Administrative – Minor and absorbable

P – None known

O – None known

* Approved by the Board

CALIFORNIA STATE TEACHERS’ RETIREMENT SYSTEM
LEGISLATIVE SUMMARY – INVESTMENT COMMITTEE
1999-2000 Regular Session – April 18, 2000

BILL NO. >>> STATUS <<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<

SB 1928

AUTHOR: Senator Haynes
TITLE: Capital Markets Task Force
LOCATION: Senate PE&R
BOARD POSITION: Oppose (Staff recommendation)

SUMMARY: Creates a task force to oversee and review investments by CalSTRS and CalPERS for purposes of identifying human rights, national security and other social concerns that could affect investment performance.

COSTS: Benefit program – None

Administrative – Probably no significant direct cost for task force.

P – None known

O – None known

SB 2122

AUTHOR: Senator Ortiz
TITLE: Joint Retirement System Investment Advisory Board
LOCATION: Senate PE&R
BOARD POSITION: Oppose (Staff recommendation)

SUMMARY: Creates advisory board to make recommendations to CalSTRS and CalPERS on asset allocation and active versus passive investments.

COSTS: Benefit program – None

Administrative – Unknown

P – None known

O – None known

L E G E N D OF ABBREVIATIONS

P = PROPONENTS O = OPPONENTS

ABBREVIATION	**ORGANIZATION**
AALA	Associated Administrators of Los Angeles
ACCCA	Association of California Community College Administrators
ACSA	Association of California School Administrators
AFSCME	American Association of State, County and Municipal Employees
AFT	American Federation of Teachers
AGENCY	State and Consumer Services Agency
A.R.E.	Association of Retirees for Equity
ART	Association of Retired Teachers
BOE	Board of Equalization
BOG	Board of Governors, California Community Colleges
Cal-Tax	California Taxpayers Association
CalPERS	California Public Employees Retirement System
CalPIRG	California Public Interest Research Group
CalSTRS	California State Teachers' Retirement System
CASBO	California Association of School Business Officers
CCA	Community College Association
CCAE	California Council for Adult Education
CCC	California Community Colleges
CFA	California Faculty Association
CFT	California Federation of Teachers
CNEC	California Network of Educational Charters
CPCA	California Police Chiefs' Association
CPFFA	California Professional Firefighters Association
CRTA	California Retired Teachers Association
CSAC	California State Association of Counties
CSBA	California School Boards Association
CSEA	California School Employees Association
CSL	California Senior Legislature
CSU	California State University
CTA	California Teachers Association
DOE	Department of Education
DOF	Department of Finance
DGS	Department of General Services
DPA	Department of Personnel Administration
FACCC	Faculty Association of California Community Colleges
F.A.I.R.	Faculty Attempting to Improve Retirement
FCPHE	Faculty Coalition for Public Higher Education
FTB	Franchise Tax Board
LADSA	Los Angeles Deputy Sheriffs' Association
LAUSD	Los Angeles Unified School District

L E G E N D OF ABBREVIATIONS

P = PROPONENTS O = OPPONENTS

ABBREVIATION	**ORGANIZATION**
OCDE	Orange County Department of Education
PARS	Public Agency Retirement System
PERF	Public Employees Retirement Fund
RPEA	Retired Public Employees Association
SACRS	State Association of County Retirement Systems
SBMA	Supplemental Benefit Maintenance Account
SDCOE	San Diego County Office of Education
SEIU	Service Employees International Union
SLC	State Lands Commission
SSC	School Services of California
SSDA	Small School Districts' Association
START	State Teachers' Automation Redesign Team
TRB	Teachers' Retirement Board
TRF	Teachers' Retirement Fund
TRL	Teachers' Retirement Law
UTLA	United Teachers of Los Angeles

STANDING COMMITTEES OF THE ASSEMBLY/SENATE

Assembly PER&SS	Assembly Public Employees, Retirement and Social Security
Senate PE&R	Senate Public Employment and Retirement